Profile of the Economy

[Source: Office of Economic Policy, Office of Financial Analysis]

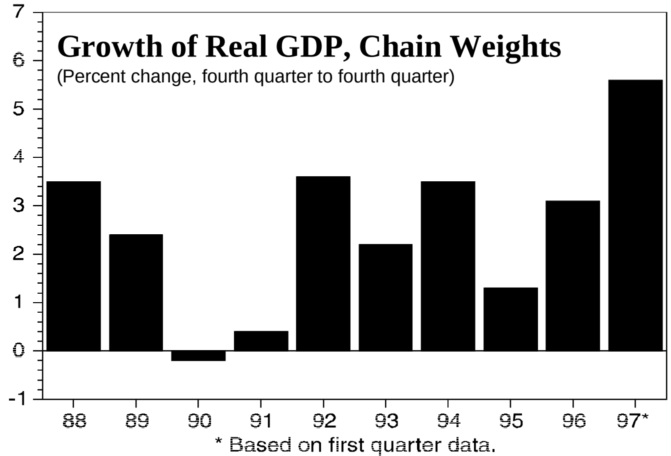
Real gross domestic product

Economic growth was very strong in the first quarter of 1997, possibly boosted by the impact of unseasonably mild weather in January and February on the seasonally-adjusted data. Real GDP grew at a 5.6 percent annual rate, well above the 3.8 percent rate in the fourth quarter and the fastest gain since the final quarter of 1987. Over all of 1996, GDP had increased by 3.1 percent.

Growth in the first quarter was led by accelerated consumer spending, which surged at a 6.4 percent annual rate compared with 3.4 percent in the final quarter of last year. Business fixed investment was also very strong, rising at an 11.9 percent pace. Large gains in both equipment and structures investment contributed to that gain. Inventory building also picked up in the quarter, accounting for 1.7 percentage points of the 5.6 percent increase in GDP.

Deterioration in the net export balance held growth down. A dramatic improvement in the trade deficit in the fourth quarter, which may have reflected difficulties of seasonal adjustment, was just about reversed in the first quarter. Excluding the foreign trade sector, gross domestic purchases were up at a stunning 7.3 percent annual rate.

Inflation generally remained moderate in the first quarter. The chain-weighted price index for GDP rose at a 2.7 percent annual rate compared with just 1.9 percent in the fourth quarter, but most of the acceleration reflected the fact that declines in crude oil prices had not yet worked through to final purchases. In contrast, the domestic purchases index, which includes imports and thus fully reflected the drop in oil prices, increased at a more moderate 2.2 percent annual rate in the first quarter.



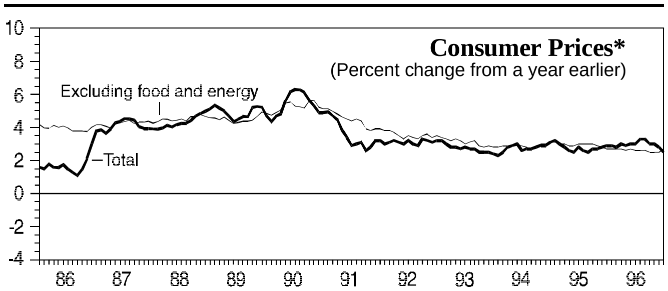
Consumer and producer prices

After a favorable performance in 1996, inflation has remained well contained thus far through 1997. Food and energy prices have moderated following some acceleration last year, while "core" inflation, which excludes the volatile food and energy components, remains fairly constant.

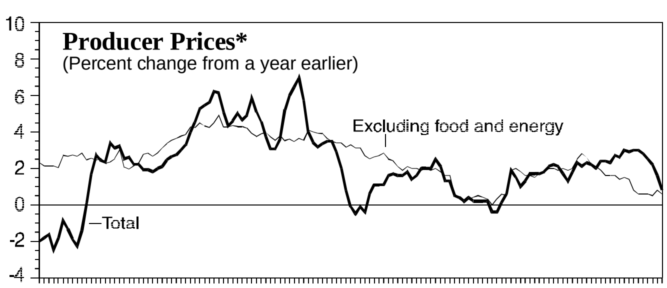
The consumer price index (CPI) rose by 1.5 percent at an annual rate through the first 4 months of 1997, well below the 3.3 percent increase during 1996. Food and energy prices were responsible for all of the deceleration, reversing course so far this year after rising sharply last year. The core CPI advanced at a 2.7 percent pace through April. This falls within the 2-1/2 to 3 percent range of the last several years and is well below the pace for the early 1990's.

Declines in food and energy prices at the producer level have resulted in a decrease of 4.0 percent at an annual rate in the producer price index (PPI) for finished goods so far this year. On a core basis, finished goods prices have been flat after edging up just 0.6 percent in 1996. The recent low for this series was in 1993, when producer prices rose by 0.4 percent over the year. Price pressures have been largely absent at earlier stages of processing.

The cost of compensating labor, which typically rises when labor markets are tight, accelerated only a little last year and remained moderate in the first quarter of 1997. The employment cost index rose 2.9 percent during 1996, little different from the 2.7 percent increase of 1995, and roughly maintained that pace in the first quarter. A slight speedup in the growth of wages and salaries was partially offset by a further slowdown in benefit costs.



*Year tick marks correspond with June data.



Real disposable personal income and consumer spending

Real disposable (after-tax) personal income rose at a rapid 6.4 percent annual rate in the first quarter of 1997, much faster than the 2.6 percent rate of growth in the previous quarter and over all of 1996. Special factors played a role, particularly the unseasonably mild winter weather which boosted employment in the quarter and hence aggregate wages and salaries.

Growth in real consumer spending also accelerated in the first quarter, fueled by the rapid increase in income. Consumption expenditures rose at a 6.4 percent annual pace in the first quarter, the fastest rate since the first quarter of 1992 and well above the 3.4 percent rate of growth in the fourth quarter. Some spending may have been pulled into the first quarter by the mild weather and an earlier than usual distribution of tax refunds. Preliminary indicators for April suggest that consumer spending is likely to show much slower growth in the second quarter.

The share of after-tax income devoted to personal saving remained unchanged at 5.1 percent in the first quarter, the same as in the final quarter of 1996. For 1996 as a whole, the personal saving rate averaged 4.9 percent, up slightly from 4.7 percent in 1995 and a low 3.8 percent in 1994.

Industrial production and capacity utilization

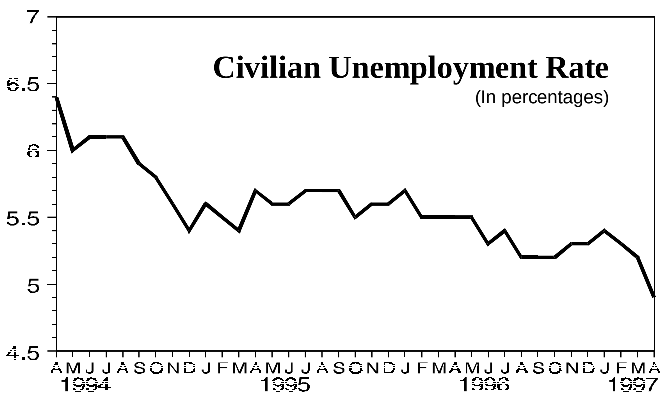
Industrial production in manufacturing, mining, and utilities has grown at a 3.4 percent annual rate through the first 4 months of 1997, following an increase of 4.3 percent during all of 1996. This is substantially above growth of 1.1 percent registered during 1995.

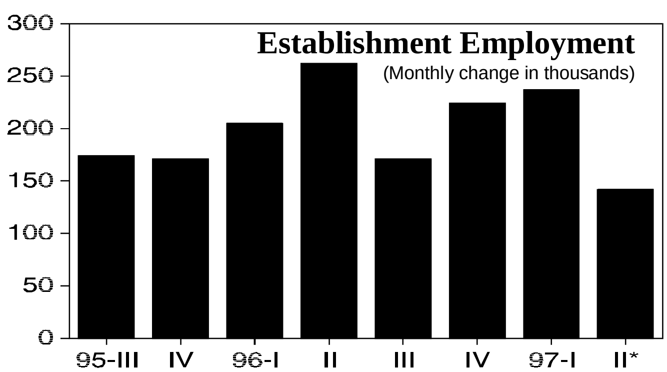
Manufacturing production, which accounts for about 86 percent of industrial production, has grown at a 3.3 percent rate since last December. Within manufacturing, the production of computer equipment has shown big advances. Production of motor vehicles and parts has grown relatively slowly on balance recently, and was held down by strikes in April. Output of utilities was strong in April because of the unusually cool weather.

The industrial capacity utilization rate has averaged 83.5 percent through April of this year, up from 83.1 percent averaged last year. Currently, the rate is about 1.4 percentage points below the peak rate for the current business cycle expansion of 84.9 percent. The long-term average for the years 1967-1996 was 82.1 percent.

Employment and unemployment

The labor market continued to show considerable strength although job gains slowed in March and April from more rapid growth earlier in the year. The unemployment rate fell to 4.9 percent in April, the first time below 5 percent since the end of 1973.





* Based on data for April.

Increases in jobs on nonfarm payrolls averaged 140,000 per month in March and April, half the average gain in the prior 2 months. Job growth in those earlier months may have been artificially boosted due to unseasonably mild weather, and the average for the entire year so far of 214,000 per month is about in line with average increases in 1996.

Most of the new jobs added in 1997, as in past years, were in the private service-producing sector. Manufacturing jobs, in contrast, have been about flat since January and construction employment fell back after a weather-related surge in February. Despite weaker job growth, hours worked in the manufacturing sector continued to expand through April as the average workweek rose to 42.2 hours, a level reached only once before in post-World War-II history, and overtime hours hit 5 per week, the most since this series began in 1956.

The low 4.9 percent unemployment rate in April suggests a very high rate of labor utilization. That this has occurred without much evidence of upward pressure on labor costs is partly due to rapid expansion in the labor force. The labor force participation rate rose to a record 67.3 percent in March before dipping back slightly in April.

Nonfarm productivity and unit labor costs

Nonfarm business productivity (real output per hour worked) rose by 2.0 percent annual rate in the first quarter of 1997. Growth was 0.9 percent over all of 1996, which was a bit below the long-term trend growth rate of 1.1 percent, but a marked improvement over the prior 3 years, when on balance there was no growth.

Hourly compensation costs in the nonfarm business sector rose by 4.7 percent annual rate in the first quarter, and by 3.6 percent during all of 1996. Labor costs per unit of output in the nonfarm business sector, which combine the impact of growth of compensation with that of productivity and are also a key indicator of potential inflation, were up by 2.7 percent annual rate in the first quarter, which was near the 2.6 percent increase during all of 1996. This rate of advance suggests that inflationary pressures remain moderate.

Productivity in manufacturing, included in the nonfarm business sector, grew by 3.1 percent annual rate in the first quarter and by 4.1 percent during all of 1996. Unit labor costs in manufacturing rose 1.4 percent annual rate in the first quarter, after falling 0.7 percent during 1996.

Current account balance

The current account is the broadest measure of U.S. transactions with the rest of the world, covering not only trade in goods and services but income flows as well. The deficit grew from a recent low of $10 billion in 1991 to $148 billion in both 1994 and 1995 and $165 billion in 1996. The widening reflected in large part the faster pace of U.S. economic growth compared with growth for most of our major trading partners. This brought in imports at a more rapid rate than the rate of growth of exports.

Although the current account deficit reached a large $165 billion in 1996, this still represented a modest 2.2 percent of GDP, little changed from the preceding 2 years. This was much below the 3.0 to 3.6 percent share of GDP tallied during the 1985 through 1987 period, when the deficit hit its all-time high of $167 billion.

The widening deficit in 1996 reflected a large deterioration in the balance on goods and a smaller deterioration in the balance on investment income. In contrast, the surplus in services trade improved. Growth in the investment income deficit was mainly due to rising interest payments on the rapidly growing foreign holdings of U.S. Treasury securities. Foreign investors have been attracted to Treasury securities because of interest rate differentials favoring dollar-denominated assets, as well as by the strength of the U.S. dollar.

In the first quarter of 1997, the surplus in services increased slightly, but the deficit balance on goods was above the average of the previous quarter. (Data on income flows in the first quarter are not yet available.) Deterioration in the trade balance on goods and services was a sizable drag on real GDP growth in the first quarter. The deterioration was partly due to the unwinding of special factors which had helped to narrow the deficit in the final quarter of 1996 and also reflected the continued strong growth of the U.S. economy.

Exchange rate of the dollar

The dollar began to appreciate against major foreign currencies (including the yen and the deutschemark) in mid-1995. Based on the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies, by the end of 1996 the dollar had risen by 8.4 percent from the all-time low reached in April 1995. Appreciation rapidly accelerated in 1997, and over the first 4 months of the year the trade-weighted index increased an additional 8.7 percent before falling back some in May.

Most of the dollar deterioration in 1994 was against the yen and the deutschemark, and the improvement has also been greatest against these currencies. Between April 1995 and April

1997, the dollar rose by 50 percent against the yen and by almost 24 percent against the deutschemark.

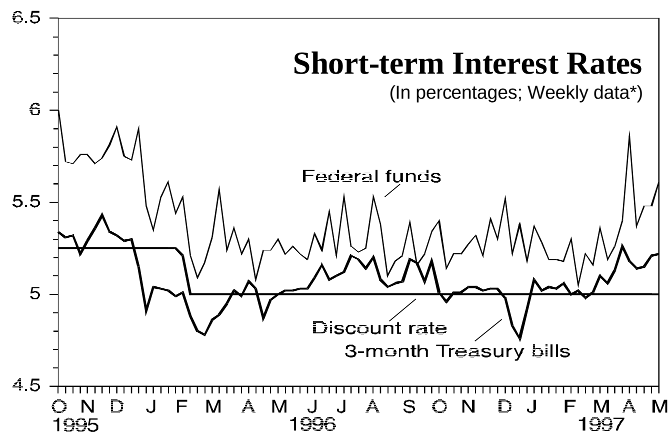
The trade-weighted value of the dollar in April almost reattained its recent high of January 1994. Many factors determine the level of exchange rates in international currency markets. Underlying economic fundamentals in the U.S. are sound and confidence in the dollar is high.

Interest rates

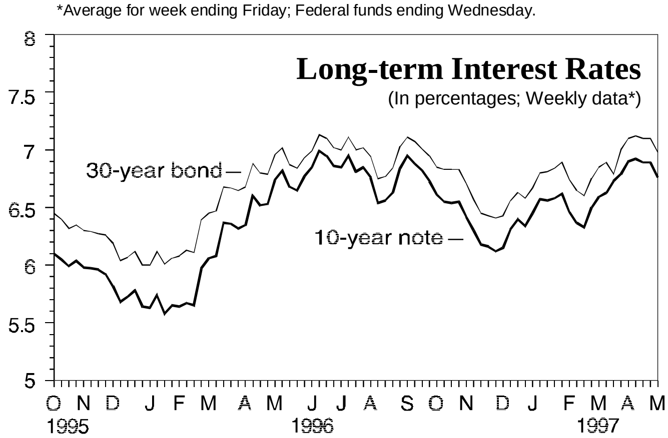
The Federal Reserve Board raised the Federal funds rate target by one-quarter of a point in March, to 5.50 percent. The Federal Reserve indicated that they took this action in light of persisting strength in demand, which was raising the risk that inflationary imbalances might develop. This was the first change in monetary conditions since late 1995 and early 1996 when the Federal Reserve eased short-term interest rates in two quarter-point increments.

Long-term interest rates moved higher in March and April, but began to ease slightly in the first half of May. The yield on the 30-year Treasury bond rose above 7 percent in April for the first time since early last fall, but recently has moved back down again.

Mortgage interest rates have exhibited a similar pattern. The rate for a 30-year fixed rate conventional loan was about 7-3/4 percent by the end of 1996, which is very low by historical standards. In early 1997 the rate moved above 8 percent but has since dipped back below that level. Mortgage rates in the 8 percent range are very favorable and have been one of the factors which helped to support growth in the housing market in 1996 and in the first quarter of 1997.



*Average for week ending Friday; Federal funds ending Wednesday.



Net national saving and investment

In 1996, net national saving, which excludes depreciation to replace worn-out or obsolete equipment and structures used in production, rose to 6.4 percent of net national product (NNP) from 5.3 percent in 1995 and as low as 3.4 percent in 1992. Despite the gains, net saving remains only half as high as the 12.5 percent of NNP averaged in the 1960's.

Recent improvement is mainly the result of the narrowing of the Federal deficit, which has reduced Government dissaving to 1.9 percent of NNP in 1996 from 5.1 percent in 1992. Private saving (of households and businesses) was equivalent to 7.7 percent of NNP in 1996, up a little from a historic low of 6.9 percent in 1994 but still lower than readings exceeding 10 percent in the 1960's and 1970's.

Net domestic investment equaled 7.5 percent of NNP in 1996, up from a low of 4.9 percent in 1991. Foreign inflows were equivalent to 2.2 percent of NNP in 1996, or nearly one-third of domestic investment. U.S. sources provided investment equivalent to 5.3 percent of NNP, less than half the share averaged in the 1960's through 1970's.

Housing

Housing activity was very strong in the first quarter of 1997, boosted by unseasonably mild winter weather through much of the country. Underlying fundamentals have also been very favorable, such as job and income growth, consumer confidence, and low mortgage interest rates. Last year was one of the best for housing in many years, and current conditions should provide further support for the housing market.

Starts of new homes totaled 1.48 million in 1996, the best year for home building since 1988. Starts accelerated to a very rapid rate in the first quarter of 1997 after weakness in the final quarter of last year, boosted in part by a weather-related surge in February. Since then starts have moderated somewhat but in April were still at a high 1.47 million-unit annual pace.

Home sales also reached new expansion peaks in 1996, contributing to the rapid growth in new starts. Sales of new single-family homes rose to 756,000 in 1996, up from 667,000 in 1995 and the highest in 18 years. Sales of existing homes topped the 4 million mark for the first time since that series began in 1968. In the first 3 months of 1997, new home sales grew to 824,000 units at a seasonally-adjusted annual rate, the highest quarterly rate in 19 years. Part of that was undoubtedly due to the unusually mild weather, and sales are likely to ease in future months to a more moderate level.

Rapid growth in employment and income and very favorable readings of consumer confidence fueled the expansion in the housing market in 1996, and these trends have continued into 1997. Mortgage interest rates for a 30-year loan have hovered near the 8-percent mark for several quarters, and in May were slightly below that level.

Federal budget deficit

The Federal budget deficit fell to $107.3 billion in fiscal 1996, the lowest in 15 years and about $57 billion below the level of the previous fiscal year. As a share of GDP, the deficit was 1.4 percent, the smallest share since 1974.

The deficit has been shrinking since fiscal 1992, when it reached an all-time high of $290 billion. Since then, it has been cut by almost two-thirds, or a total of $183 billion. Strong economic growth and passage of the Omnibus Budget Reconciliation Act of 1993 set the deficit on its downward course.

Further deficit reduction is expected over the next 6 years. The deficit in fiscal 1997 is likely to be substantially below the fiscal 1996 figure. The deficit is expected to diminish further, and budget balance is projected to be reached in fiscal 2002.